Edgemoor's Quarterly Report

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New Highs Amidst the Noise

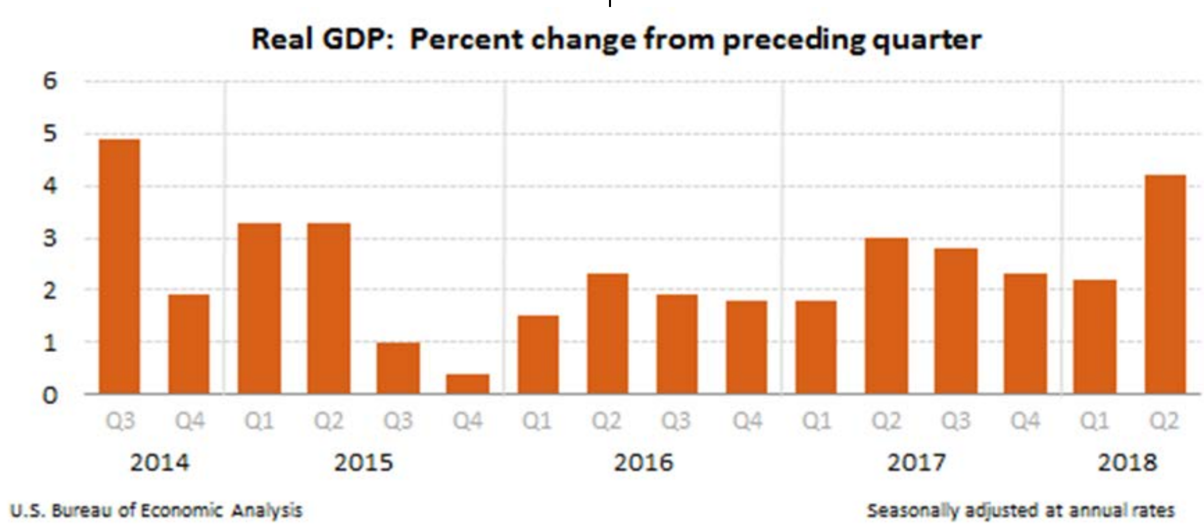
The stock market rose steadily in the third quarter to hit new highs, despite all the noise related to global trade, domestic and foreign politics, and concerns that the market may be peaking. The S&P 500 index returned 7.7%, its best quarterly gain since 2013, as investors cheered surging corporate earnings and ongoing economic expansion.

We, too, applaud the market's recent performance and are optimistic that the bull market may continue. Steady economic growth, particularly in the United States, should fuel more strong earnings reports and support higher prices. However, we are keeping an eye on rising interest rates and valuations, particularly of the specific securities we own or may want to buy. We believe the U.S. Federal Reserve can manage rates higher without triggering a recession, but we acknowledge the challenge inherent in the Fed's job. Read on for our review of the third quarter and forecast of what is to come.

Third Quarter Review

The primary catalysts for stocks' third quarter rise were solid economic growth, particularly in the United States, and outstanding corporate earnings reports. As shown in the chart below, the U.S. economy as measured by gross domestic product (GDP) expanded 4.2% in the second quarter, up from 2.2% in the first.

Boosted by strong consumer and business confidence and the recent tax cuts, corporate earnings continued their streak of robust increases.



Past performance is not indicative of future results.

Earnings surged 25% for the second straight quarter, and 80% of companies topped analysts' estimates, the highest percentage since FactSet began tracking this data in 2008.

Interest rates continued their steady rise, with the yield on the 10-year Treasury climbing above 3%, near its seven-year high but still low by historical standards and a reflection of economic optimism. The Fed hiked the federal funds rate 0.25% again in September to 2.25% and confirmed plans to increase rates once more before year end, subject to change based on future economic data.

Employers hired an average of 190,000 workers in the quarter, below the average of 211,000 for the first nine months of 2018 but ahead of the rate of 182,000 last year. The unemployment rate dropped in September to 3.7%, the lowest level since 1969, and wage growth remained in the range of 2.8%-2.9% for the quarter. Despite these positive indicators, there are signs that the labor market is tightening. One major announcement was retailing behemoth Amazon's move to raise the minimum wage it will pay its workers to $15 per hour, a decision that may put pressure on other retailers and employers to boost pay as they recruit for the upcoming holiday season (though other changes may offset at least a portion of Amazon's increase).

The markets and the economy delivered their solid performances amidst a backdrop of trade disagreements, political squabbles, and signs of slowing growth and other economic concerns abroad, particularly in emerging markets. On the last day of the quarter, the United States, Mexico, and Canada announced a new agreement to replace the North American Free Trade Agreement, or NAFTA. The new agreement updates some NAFTA provisions for the digital age, modifies content requirements for automobiles, and sets minimum wages for auto industry workers, among other changes. Most of all, the market saw the announcement as an encouraging sign of progress on trade issues and a reason to hope for resolution of disputes with China, Europe, and others.

Our Forecast and What We're Watching

We expect that economic growth and corporate earnings increases will continue, presenting an opportunity for more gains in the stock market. We think the U.S. economy will remain healthy, though GDP growth will likely moderate somewhat in the second half of this year, resulting in an increase of about 3% for all of 2018. The Federal Reserve Board projects GDP growth in the range of 2%-2.5% in 2019 and 2020, slightly lower than the current rate but still relatively strong. We also expect foreign economies to expand, though likely at slower rates than here at home.

Analysts expect third quarter corporate earnings to rise about 19%, a result that would be welcome news to investors and would, in our opinion, support higher stock prices. We believe earnings growth will remain strong through the end of this year but will moderate next year, since comparisons will be to the quarters this year that already benefited from the tax cuts.

The Fed will likely raise the federal funds rate again in December, and we expect interest rates on government and corporate bonds to rise gradually as labor markets tighten and inflation picks up. For now, we view increasing rates as an expected and reasonable result of steady economic growth.

Inflation remains tame currently, and we do not expect a sharp rise in either inflation or interest rates in the near term.

We will be keeping a close eye on several important domestic and global issues. The upcoming midterm elections in the United States may bring change to Congress that could slow the trend toward lower regulation and taxes. We hope to see progress on the trade disputes that are bringing uncertainty to businesses and threaten to offset the benefits to earnings provided by the corporate tax cuts. In our opinion, imposition of significant additional tariffs and further deterioration of our relationships with foreign trade partners would be detrimental to the economy and markets.

Looking abroad, Great Britain is struggling to develop a plan for Brexit, its exit from the European Union in March 2019. A messy Brexit could hurt the European economies and impact others around the world. Italian debt issues also threaten to disrupt economic growth in Europe. Emerging markets are dealing with tariff disputes and the challenges presented by a strong U.S. dollar, which makes those countries' dollar-denominated debt and oil imports more expensive. Beyond economics and finance, North Korea's nuclear arms and unrest in the Middle East are also potential threats that we are watching.

The S&P 500 index now trades for about 16.8 times projected earnings for the next twelve months, the same as at the end of the second quarter and roughly in line with long-term levels. We consider the stock market overall to be reasonably valued and believe the securities we own, which trade at an average price/earnings ratio lower than that of the broad market, to be underpriced relative to our estimates of their intrinsic values.

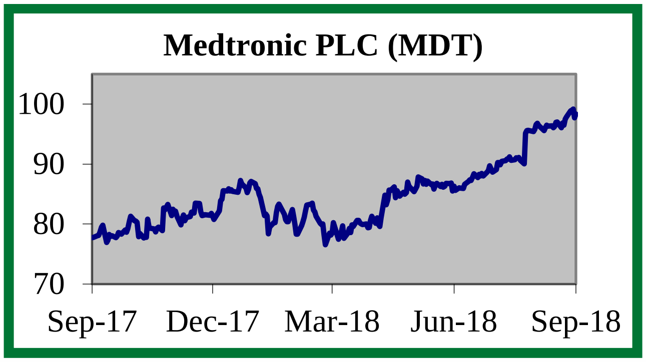
We are disappointed that the foreign stocks we own have generally underperformed the domestic stocks in our portfolios, a reflection of the broad outperformance of U.S. stocks due to tax cuts, the relatively strong U.S. economy, the strength of the dollar relative to other currencies, and the higher representation of technology stocks in the U.S. benchmarks. However, we believe that foreign stocks will perform better than U.S. stocks at times in the future, as they often have historically, and remain confident that they belong in a diversified, long-term portfolio. We also like that they generally trade at lower multiples of earnings than U.S. stocks.

While cautiously optimistic on stocks, we remain wary of long-term bonds, as we expect interest rates to move higher as the economy continues to expand and wage pressures increase. We are buying some bonds with short- to intermediate-term maturities to provide some ballast to our portfolios in the event of a sharp downturn in the stock market. These bonds are less sensitive than longer-term bonds to changes in interest rates. We have also bought shares of a floating-rate fund, discussed later in this report, which invests in loans with rates that will adjust higher if interest rates continue to rise. However, we continue to favor other asset classes for most of our income holdings, including pipeline companies, utilities, telecommunications companies, real estate investment trusts, business development companies, and preferred stocks.

Analysis of Selected Securities

Following is a discussion of three securities we own and have bought recently. Due to factors specific to each company, these stocks are, in our opinion, priced attractively in the markets today.

Medtronic PLC (MDT)



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Price (09/30/2018)	$ 98.37		Forward P/E	19.4
Market Cap ($B)	$ 133.8		Price/Book	2.7
Dividend Yield	2.0%		Price/Sales	4.5
Return on Equity	6.3%			

One of the world's largest medical device companies, Medtronic offers a broad range of products and therapies to treat various chronic diseases, including cardiac disease, neurological and spinal conditions, and diabetes. The company operates in four business segments: Cardiac and Vascular Group (38% of total revenues), Minimally Invasive Technologies Group (29%), Restorative Therapies Group (26%), and Diabetes Group (7%). Medtronic is domiciled in Ireland, does business in more than 120 countries worldwide, and generates 47% of its revenues outside the United States.

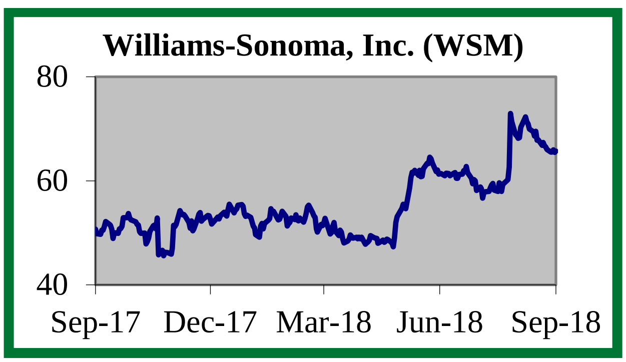
Medtronic has long been known for product innovation and an ability to be the first to market with new products and therapies. The company spends heavily on research and development and has committed to invest an incremental $10 billion over the next decade.

Medtronic has consistently delivered 6%-7% annual sales growth over the last decade. Its recent growth stems from a substantial lineup of new products in cardiac care, surgical robotics, and diabetes, areas in which the company has seen double-digit sales growth. In the company's core portfolio, heart devices (pacemakers, stents, and heart valves) command as much as 50% market share, while its spinal products and insulin pumps also enjoy top market positions. We believe the large and diversified nature of Medtronic's product portfolio insulates the company from fluctuations in any particular product line and allows for smooth and consistent earnings growth.

Medtronic enjoys a wide economic moat tied to its market dominance, product innovation, and intellectual property. According to the Patent Board, an independent publication, Medtronic holds the strongest patent portfolio among its peers, based on the number and technological strength of its patents. The company's moat is also derived from other competitive advantages, including strong relationships with doctors and hospitals who depend upon the company's deep device knowledge and expertise, creating high switching costs for its products.

Medtronic is financially sound and shareholder friendly. Net profit margins have consistently been above 20%, and returns on invested capital of nearly 20% are double the company's cost of capital. Medtronic generates free cash flow of almost $4 billion per year and has a strong balance sheet, with $24 billion of long-term debt and $11 billion of cash and marketable securities. MDT shares are attractively valued at 19.4 times forward earnings, in line with industry averages. Management is committed to returning at least 50% of free cash flow annually to shareholders and recently increased the dividend by 9% to yield 2.0%. Medtronic's management and board get high marks for stewardship, with nine of the eleven board seats held by outsiders. We believe Medtronic is a good, long-term holding with solid return prospects.

Williams-Sonoma, Inc. (WSM)



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Price (09/30/2018)	$ 65.72	Forward P/E	14.5
Market Cap ($B)	$ 5.2	Price/Book	4.8
Dividend Yield	2.7%	Price/Sales	1.0
Return on Equity	23.3%		

Williams-Sonoma Inc. is a specialty retailer of home furnishing products. The San Francisco-based company operates 631 retail stores under the Williams-Sonoma, Pottery Barn, Pottery Barn Kids, PBTeen, and West Elm brands, with most in the United States and 19 stores in Australia and 2 in the United Kingdom. In-store sales accounted for 48% of total revenues of $5.3 billion in fiscal year 2018, while the fast-growing e-commerce and direct-mail business accounted for 52% of total revenues.

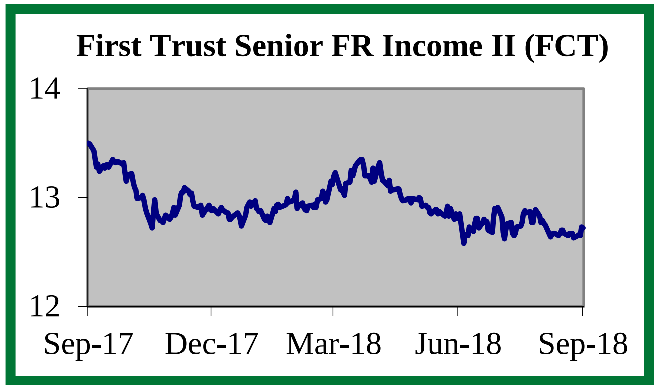
Williams-Sonoma has carved out a solid niche in the highly fragmented $116 billion home furnishings industry and is known for its strong brand recognition, smart marketing and merchandising, and customer loyalty. The company is unique among traditional retailers in how well developed and rapidly growing its e-commerce presence has become. Williams-Sonoma has successfully combined its expertise in digital marketing and e-commerce analytics with its track record for developing unique products and brands to capture significant market share in the high margin, direct-to-consumer business segment. With over half of its sales derived from this e-commerce strategy, Williams-Sonoma has been able to build its brands efficiently and cost-effectively among customers who increasingly want to shop online.

Williams-Sonoma gains a competitive edge by developing unique and proprietary merchandise that it sources on an exclusive basis from vendors around the world. Management estimates that 85% of its products are proprietary, meaning that they have been designed and produced on an exclusive basis with a vendor from one of the 43 countries in its supply chain. This direct sourcing and the company's growing distribution and delivery network are sources of Williams-Sonoma's economic moat and defensible market position.

Another distinct competitive advantage for Williams-Sonoma is its sophisticated data analytics operation. Having collected insights and buying patterns on its customers for more than 25 years, something that very few retailers have been doing until recently, the company is able to use this deep customer knowledge to market tactically and build new brands based on both predictive and demographic patterns of buying. For example, the West Elm brand, launched in 2002 and the company's highest growth segment, caters to the lifestyle cycles of millennials, targeting their initial home furnishing purchases. As they age and upgrade, these customers become natural consumers of higher-ticket products from Pottery Barn and Williams-Sonoma. And as they marry and have children, they in turn become natural buyers of PB Kids and PB Teen products. This attention to the full life cycle of its customers has resulted in less capital being needed to generate the next incremental sale and has led to industry-leading margins, loyal customers, and sustainable brands.

Williams-Sonoma's return on equity tops 23%, and its five-year return on invested capital is better than 17%, both higher than peer and industry averages. Management has consistently returned excess cash to shareholders, spending approximately $1.7 billion over the last five years on dividends and share buybacks. In our opinion, Williams-Sonoma shares are attractively valued at 14.5 times forward earnings, compared to a market average of just under 17 times for the S&P 500 index, and pay a sustainable and growing dividend currently yielding 2.7%.

First Trust Senior FR Income II (FCT)



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Price (09/30/2018)	$ 12.72	NAV	$14.04
Market Cap ($M)	$ 336.1		
Dividend Yield	5.7%		

First Trust Senior Floating Rate Income Fund II (FCT) is a diversified, closed-end fund that invests primarily in a portfolio of senior secured floating-rate corporate loans. These loans pay a floating rate coupon that is typically tied to the three-month London interbank offered rate (Libor), meaning that as Libor rises so does the coupon paid by the senior loan. The floating rate feature significantly reduces interest rate risk, an attractive feature in a rising interest rate environment such as we have seen this year.

Senior loans generally hold the senior position in the capital structure of the issuing company and are typically secured by specific collateral. Consequently, holders of the loans have a senior claim on the assets of the company in the event of financial difficulties, ahead of subordinated debt holders or equity holders.

FCT's senior loan portfolio is broadly diversified across companies and industries, with no one holding representing more than 3% of total fund assets and the top ten holdings representing less than 25% of total fund assets. The top five industries in the fund are healthcare (16%); hotels, restaurants, and leisure (13%); software (12%); pharmaceuticals (7%); and life sciences (5%).

FCT offers an attractive 5.7% dividend yield that can increase as interest rates rise, and the shares trade at a discount to net asset value, a relationship that offers price appreciation potential if the discount narrows. We currently buy FCT in income portfolios for both its current yield and its potential to hedge against rising interest rates.

Source for charts and text: Morningstar, S&P, Schwab, ValueLine, Black Diamond Performance Reporting, Yahoo Finance, and Argus reports.

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INVESTMENT ADVISORS

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